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IN THE

Supreme Court of the United States

OCTOBER TERM, 1962

No. 945

JACK AND CELIA FARBER, *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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The Petitioners, Jack and Celia Farber, petition for a Writ of Certiorari to review the judgment of the Court of Appeals for the Second Circuit in this case.

OPINIONS BELOW

The findings of fact and opinion of the Tax Court, Judge Drennen dissenting, (App. pp. 1a-28a) are reported at 36 T.C. 1142. The opinion of the Court of Appeals dated January 11, 1963 (App. pp. 31a-43a), is not yet reported.

JURISDICTION

The judgment of the Court of Appeals was entered January 11, 1963 (App. p. 44a). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether Section 117(m) of the Internal Revenue Code of 1939 which provides that gain "from the sale or exchange of * * * stock of a collapsible corporation" is taxable as ordinary income rather than as capital gain is applicable even though the gain realized on the sale of the stock is not attributable to property constructed by the collapsible corporation.

2. Whether the limitation contained in Section 117(m)(3)(B) of the Internal Revenue Code of 1939 which provides that Section 117(m)(1) shall not apply "to the gain recognized during a taxable year unless more than 70 per centum of such gain is attributable to the property so manufactured, constructed, produced, or purchased;" requires a factual determination of what portion of the gain, if any, is attributable "to the property so manufactured, constructed, produced, or purchased" by the "collapsible corporation" where there is substantial evidence in the record from which such a factual determination can be made.

3. Whether Section 117(m) of the Internal Revenue Code of 1939 is inapplicable in circumstances where the stockholder would have been entitled to capital gain's treatment had he held title to the property in his individual name instead of a corporation. This question is presently before this Court on Certiorari from the United States Court of Appeals for the Second Circuit in *Braunstein* v. *Commissioner*, No. 476. Cert. Granted December 10, 1962.

STATUTE INVOLVED

Section 117(m) of the Internal Revenue Code of 1939 is printed in Appendix B, *infra*, pp. 45a-46a.

STATEMENT OF THE CASE

The facts are found by the Tax Court (App. pp. 2a-13a) and may be summarized as follows:

The taxpayers are husband and wife residing in West Hempstead, Nassau County, New York. Beginning in 1939, Jack Farber purchased one-family dwellings. Later he began constructing apartment houses for investment. In May, 1950, he formed Eagle Mount Corp. and owned all its stock. It had no assets at this time. On July 18, 1951, he contracted to purchase a tract of land in the Village of Garden City, Nassau County, New York. The total contract price was $46,000, with $10,000 down and the balance payable two years from the date of closing title.

The tract of land was unimproved and had been subdivided on an existing map into 20-foot lots. Farber had intended to erect one-family dwellings on the land for sale. On July 25, 1951, he assigned to Eagle Mount his interest in the July 18, 1951, contract. The sale of the land was consummated May 8, 1952, and title conveyed to Eagle Mount. This was its only asset. It later delivered to the seller its promissory note for $35,500 to secure payment of the balance of the purchase price. Jack Farber had furnished the difference.

Thereafter, Farber made arrangements to revise the map of the tract of land to 60-foot lots instead of 20-foot lots. The architect was paid $300.00. Application was made to the Village of Garden City for permits to erect 29 houses (81 were subsequently erected)

at a cost of $3,581.50. A bond was filed at a cost of $546.00 to secure the cost of water, sewer and street improvements. There was deposited $6,200 to cover cost of materials for the street and utility connections. Eagle Mount filed an application with the FHA for conditional commitments to insure loans on the proposed 29 houses to be built and a fee of $1,305 was paid to the FHA. No insurance loan commitments were obtained. Farber advanced all these funds.

After these preliminary activities and before anything had been done to the property, Farber was contacted by two builders who had recently completed a housing development in the adjoining County of Queens. They desired to acquire the whole of the land in question, but Farber refused to sell. After further negotiations, however, an agreement was reached for their participation in a project calling for the construction and sale of 81 houses on the land. At the insistence of counsel for the builders, a new corporation was formed on November 5, 1952, (Eagle Garden Homes, Inc.) to carry on this development. The stock in the new corporation was held equally between Farber and the builders.

A capital investment in the corporation of $30,000 was made; $15,000 by Farber and $15,000 by the two builders. The agreement entered into provided that Ferber would sell his entire stock interest in the land-holding corporation, Eagle Mount, in return for a note of the new corporation in the amount of $160,000, bearing 4% interest. Farber held the stock as security for payment of the note and it was agreed that as payments were made on the note, Farber would cause Eagle Mount to release parts of the land. Farber likewise would make payments on the mortgage and obtain

releases as such payments were made. Eagle Garden met its obligations under the note, paying to Farber $2,500 per lot (out of the construction loans from the bank, which were arranged by Eagle Garden, when construction on the lot reached a certain state.) In addition, out of the profit on each house, the builders were to, and did, receive payment on each house during construction in varying amounts of $130.00 minimum to $250.00 maximum as their building fee per house. The balance of the profits remained with Eagle Garden. Eagle Garden also reimbursed Farber for the preliminary expenditures theretofore made by him in connection with the proposed original erection of the 29 homes by Eagle Mount.

In January, 1953, Eagle Garden commenced construction of the 81 one-family houses on the land and entered into contracts for various phases of the construction activities, including a contract with a sales agent for the entire project. Eagle Garden made all arrangements for obtaining the construction loans and as construction advanced, made payments of $2,500 per lot in curtailment of the $160,000 note to petitioner. No payments were made in 1952. In 1953, payments totaling $77,500 were made representing 31 lots, and in 1954, the balance of $82,000 covering 33 lots was paid. Eagle Garden had constructed 64 houses on the land by the end of 1954, and thereafter completed the 81 house project.

REASONS FOR GRANTING THE WRIT

The Decision below that Eagle Mount was a collapsible corporation and that under Section 117(m) the gain realized by the taxpayer on the sale of his stock in Eagle Mount is taxable as ordinary income under Section 117(m) of the 1939 Internal Revenue Code is

patently in error. This case involves important questions of Federal law which have not been but should be decided by this Court. The questions involved are important to the proper administration of the Internal Revenue laws and for guidance to the taxpaying business community. The Decision below is in direct conflict not only with the statutory language of Section 117(m) but the expressed Congressional intent to be achieved by the statute. The Decision is in conflict with the decision of the Court of Appeals for the Fifth Circuit in *United States* v. *Ivey*, 294 F. 2d 799 (1961). This Court granted certiorari on question Three (3) presented herein in view of the conflict of *Ivey* with the decision of the Second Circuit in *Braunstein* v. *Commissioner*, 305 F. 2d 949 *cert. granted*, December 10, 1962 (Docket No. 476).

ARGUMENT

I

The statute is aimed to prevent taxpayers from obtaining the benefits of capital gain tax rates in cases in which corporations had constructed property and before the net income to be derived from such property had been received the stockholders disposed of their stock by liquidation or sale taxable at capital gain rates. The classic illustration referred to in the legislative history (S. Rep. No. 2375, 81st Cong., 2d Sess. 90; 1950-2 C. B. 483, at 516) is the production of a motion picture which would be expected to be income-producing and upon which ordinary income tax rates would be applicable. To avoid payment of ordinary income taxes upon the net income from the produced picture and to obtain capital gain, the producer "*Upon completion of the film*," but prior to the realization by the corporation of any income therefrom, liquidates the corporation or sells his stock. The corporation paid no

income tax as it had realized no income from the produced picture. The producer paid capital gain tax on the increase in value of the production received in liquidation or on the gain realized upon the sale of the stock. The Committee Report likewise refers to the same device employed in the building construction trade, "by contractors who *have corporations construct buildings for sale* and *then liquidate* the corporations and sell the buildings as individuals."

The same legislative history makes it clear that the statute is only to be made applicable in cases where "the gain realized from the sale or exchange of the stock during the year *is more than* [or] *attributable to property produced by the corporation*, * * *" [Emphasis added.]

The Court below erroneously holds that if there are activities carried on by the corporation which constitute "construction * * * to any extent," Section 117(m) is applicable whether or not the corporation had constructed or produced anything of value from which net income might have been realized at the time of sale of stock or liquidation.

The Court below decides that there is no force to the argument that the statute requires construction of property of substantial value by the so-called collapsible corporation out of which ordinary income might be expected to be derived prior to the sale of its stock, before Section 117(m) can be applicable; that such an interpretation is "inconsistent" with both the language and the announced Congressional purpose. It is respectfully submitted that the Court below has misconstrued the statute and the announced Congressional purpose. If this erroneous doctrine is permitted to stand, the collapsible provisions of the Internal Revenue Code will be expanded far beyond their intended

purpose. See the dissenting Opinion of Justice Drennen of the Tax Court (App. pp. 27a-28a).

The statute defines a collapsible corporation as one "formed or availed of principally for the manufacture, construction, or production of property * * * with a view to (i) sale or exchange of stock by its stockholders * * * prior to the realization by the corporation * * * constructing * * * the property of a substantial part of the net income to be derived from such property, * * *." It is respectfully submitted that this means that the corporation must have constructed property, and that the property so constructed must be capable of producing net income.

In the instant case, if the preliminary activities of Eagle Mount are considered to constitute construction * * * to any extent, we submit that this is, in itself, not sufficient. It must have been clear that the property constructed was capable of producing net income, for otherwise no tax at ordinary income tax rates could have been avoided at the date of sale. Eagle Mount had neither constructed, produced or created anything of value from which income could have been derived (much less net income) at the date of the sale of its stock on November 18, 1952.

The Opinion below would deem every corporation be a collapsible corporation and gain from sale of its stock taxable at ordinary income tax rates under Section 117(m), irrespective of the extent of so-called construction activities by such corporation or whether or not anything of value had been created, produced or constructed by such a corporation. The fact that the gain on sale of stock or upon liquidation may be attributable to increment in value of property or to other factors, as in this case, are deemed irrelevant. In

the instant case, it is apparent that the gain derived by the taxpayer on the sale of his stock in Eagle Mount to Eagle Garden Homes was attributable to construction activities carried on by Eagle Garden after the date of the sale of the Eagle Mount stock. In view of the short holding period it is not likely that the gain was attributable to an increase in the value of the land. But if so section 117(m) would not cause the gain to be taxable as ordinary income. There were no activities of Eagle Mount which could account for this substantial increase in value. The purchase price was paid and gain realized only as construction proceeded successfully by Eagle Garden. Nothing was paid—and no gain realized in the year of sale, 1952. It was not until the years 1953 and 1954, as Eagle Garden produced, that the taxpayer was paid for the land held by Eagle Mount and thus derived the realized gain upon which the tax is to be imposed.

Accordingly, it is respectfully submitted that because Eagle Mount had constructed no property of value from which income could "be derived," it was not a "collapsible corporation" within the meaning of Section 117(m)(2). This Court should not permit the erroneous doctrine annunciated below to stand as a precedent in the administration of this very important provision of the Internal Revenue laws.

II

Section 117(m)(3)(B) provides

> "(B) This subsection shall not apply to the gain recognized during a taxable year unless more than 70% of such gain is attributable to the property so manufactured, constructed, produced, or purchased; * * *"

The taxpayer argued that this limitation means that for the gain to be taxable as ordinary income, at least 70% of the gain must be attributable to construction by the so-called collapsible corporation. The Court admits that the Commissioner's Regulations, Section 39.117(m)(1)(C)(3)(ii)-(1954), are "cut somewhat, although perhaps not decisively, against the taxpayer." The Court admits that "The legislative history tells us that the purpose of the 70% clause was 'to insure that the application of the sub-section would be limited to those corporations where the relationship to the gain realized and the property constructed or produced is substantial.' H. R. Rep. No. 2319, Sen. Rep. No. 2375, 81st Cong., 2d Sess. (1950), in 1950-2 Cum. Bull. at 451, 548."

However, the Court below attempts to avoid the question by stating that Farber had the burden of bringing himself within the 70% clause and made no attempt to do so and that Congress did not intend by the 70% clause to "require that in every such case, there must be an allocation of 'gain' on a before and after basis to determine whether the sub-section was to apply." As the Court stated:

> "A determination how much of petitioner's gain was in respect of what had been done by Eagle Mount prior to November 18, 1952, and how much was in respect of what Eagle Garden was committed to do on Eagle Mount's property thereafter, would be an attempt to separate the inseparable."

The facts of record clearly show that the taxpayer did present substantial evidence showing that he was within the 70% rule. The Court, we submit, is required in every such case by the very terms of the statute to make a determination on the basis of the

evidence presented as to whether at least 70% of the gain is attributable to construction by the collapsible corporation. The evidence as introduced in this case and the facts as found by the Tax Court clearly show that nothing more than preliminary steps were taken after Eagle Mount acquired title to the land in July, 1952, and prior to sale on November 18, 1952, and these minor activities only with respect to 29 of the 81 homes actually constructed on the land by Eagle Garden. The following is a statement of the activities of both Eagle Mount and Eagle Garden as found by the Tax Court, or otherwise clearly shown from the evidence:

ACTIVITIES OF EACH CORPORATION

Eagle Mount (In relation to only 29 of the proposed 81 houses.)	Eagle Garden (In relation to 81 houses constructed.)
Hired an architect to revise the old plat [Appendix, *infra*, (Tr. 172)].	Paid Eagle Mount for Eagle Mount's expenses in accomplishing its preliminary activities listed [Appendix, *infra*, (Tr. 175)].
Application for permits from the Village for the erection of 29 single family houses [Appendix, *infra*, (Tr. 173)].	Supervised the construction of 81 houses erected on the property [Appendix, *infra*, (Tr. 176)].
Made arrangements for the future installation of water, sewers, and street improvements (filed a bond therefor) [Appendix, *infra*, (Tr. 173)].	Assumed a contract of an excavator made by Eagle Mount for $100 per house on 29 houses [Appendix, *infra*, (Tr. 177)].
Deposited an amount for the purchase of materials for the above improvements [Appendix, *infra*, (Tr. 173)].	Entered into subcontracts for excavations, sidewalks and curbs, heating and plumbing, "I" beams and other steel, "dry-wall" installations, damp-proofing, painting, and paper hanging for 81 one-family houses to be constructed on the land [Appendix, *infra*, (Tr. 180)].
Filed applications with FHA for conditional commitments to insure loans covering the 29 proposed houses but none had been obtained [Appendix, *infra*, (Tr. 173)].	

Eagle Mount (In relation to only 29 of the proposed 81 houses.)	Eagle Garden (In relation to 81 houses constructed.)
(continued)	(continued)
	Let contracts for hot water heaters and weather-stripping [Appendix, *infra*, (Tr. 180)].
	Entered into a contract with a sales agent for the project [Appendix, *infra*, (Tr. 180)].
	Made arrangements with a bank for obtaining construction loans [Appendix, *infra*, (Tr. 180)].
	Paid $2,500 per lot in curtailment of its obligation of $160,000 to the petitioners [Appendix, *infra*, (Tr. 180-181)].
	Purchased some additional land [Appendix, *infra*, (Tr. 181)].
	Constructed 64 houses on the land in question by the end of 1954 and thereafter completed the 81 house project [Appendix, *infra*, (Tr. 181)].
	Sold enough of the houses to pay off its $160,000 note plus interest at 4% by the end of 1954 [Appendix, *infra*, (Tr. 181)].

The land in question was purchased as heretofore recited under contract dated July 18, 1951, for a total consideration of $46,000. Eagle Mount acquired title in May 1952. It was sold to Eagle Garden on November 18, 1952, for a $160,000 note which the parties knew would be paid only from construction and development by Eagle Garden. The only reasonable conclusion that may be reached from the evidence negatives a finding

that 70% of taxpayer's gain is attributable to the activities carried on by Eagle Mount during the six months it held title. Although requested to do so, the Tax Court below (App. 28a) refused to clarify its finding of fact that "more than 70% of the gain realized by the petitioner in each of the years 1953 and 1954 from the sale of his stock in Eagle Mount was attributable to the property so constructed", by specifying to whom the phrase "property so constructed" refers (i.e., Eagle Mount, Eagle Garden Homes, Inc., or both) and the Court below erroneously concludes that such a finding is not required to be made under Section 117(m) of the 1939 Internal Revenue Code.

It is respectfully submitted that if the Decision below stands, the 70% rule as set forth in Section 117(m)(3)(B) is rendered meaningless.

III

It is clear that if the land, title to which was held by Eagle Mount, had been held in the individual name of the taxpayer, the gain on the sale of such land would have been on the sale of a capital asset and taxable at capital gain rates. See the identical factual situation in *Paul V. Morris* v. *Commissioner of Internal Revenue*, 14 T.C.M. 76 (1955). This argument was advanced before the Tax Court but not decided by it and was not renewed before the Court below. In view of its decision in *Braunstein, supra*, it would have been of no avail. The Fifth Circuit in *U. S.* v. *Ivey, supra*, holds that Section 341 of the Internal Revenue Code of 1954, which in this respect is similar to Section 117(m) of the 1939 Code, does not penalize the taxpayer by coverting his capital gain into ordinary income. The Court holds that if the taxpayer estab-

lishes that "he would have been entitled to capital gain treatment without having incorporated", the collapsible provisions are not applicable. This same question is before this Court in *Braunstein* and is clearly presented here. We believe that in view of the fact that the property herein was unimproved land upon which there was no construction, the circumstances herein would have resulted in capital gain to either the corporation or the individual since neither the corporation nor taxpayer was in the business of selling unimproved land to customers in the ordinary course of trade or business. *Paul V. Morris* v. *Commissioner*, *supra*. The plan to develop houses had been abandoned and the only asset sold was land.

CONCLUSION

For the foregoing reasons, the Petition for Writ of Certiorari should be granted.

Respectfully submitted,

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